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## THE INCOME TAX AS APPLIED TO DIVIDENDS

As is well known, the federal income tax is divided into two parts. Part one is the income tax on individuals, part two is the income tax on corporations. The division, which has an historical origin, is continued for political reasons and because it adds to the certainty and convenience of collection. It served, however, no deliberate purpose of a differentiation in tax burden before 1920.

Unlike the British property and income tax and the income tax systems of some other countries, our federal tax makes no specific distinction between different kinds of incomes. Thus there is no classification into earned and unearned income, nor is income from property treated differently from income of any other sort. It is true, however, that Congress made an analogous distinction when it imposed on corporations, in addition to the income tax, taxes on the capital stock and an excess profits tax. If there are any elements of "special privilege income" in the net earnings of corporations they are taken care of by these taxes. But these taxes, like the property taxes imposed by the states and by the local governments on sources of "unearned" income, are quite distinct from the income tax.

Although the tax on the net income of corporations began in 1909, four years before the personal income tax was first imposed, that tax is now correlated with, one may even say welded into, the personal income tax. Thus the law provides that "dividends from a corporation which is taxable . . . upon its net income" shall be allowed as a credit to the individual for the purpose of computing the normal tax. The intent is that dividends shall not be taxed again in the hands of the individual. They must, of course, be included in computing the surtaxes.

It would appear from this and from other provisions of the law that it has not been the intention *in the income tax proper*, as applied to the individual, to impose on dividends, nor on the net income received by individuals out of the earnings of corporations, any different or any heavier tax than is imposed on any other form of income such as salaries, rent, interest, or profits. Beginning in 1920, however, the normal tax on corporations is to be 10 per cent, while that on individuals is to be 8 per cent. It appears, on the surface at least, to be the intention to use the older corporation tax chiefly as a means of collection. It is a sort of "stoppage at the source," although in our statute "payment at the

source" is now a technical term, restricted to the taxation of the incomes of non-resident aliens.

In practice, however, this form of a stoppage at the source imposes a tax on some recipients of dividends, who, if their incomes were in any other form, would not be taxed, or would not be taxed as heavily as they now are. It brings it about that two persons whose incomes are the same in amount may bear very different tax burdens.

The discrimination arises in two ways. One is that the benefit of the personal exemption does not accrue, or accrues only in part, to recipients of income in the form of dividends who do not have, in addition to the dividends, other income from which the personal exemption can be deducted. The other is that the benefit of the subnormal tax, *i.e.*, 6 per cent instead of 12 per cent on the first \$4,000 in excess of the personal exemptions, does not accrue in full to recipients of dividends unless they have income other than from dividends amounting to \$4,000 over and above the personal exemption.

It is not to be assumed that the discrimination is deliberate. The working hypothesis of the law seems to be that the "average man" who has any income at all in the form of dividends has, also, enough other income to enable him to receive the benefit of the personal exemption and possibly of the subnormal tax as well. That is clearly the point in granting "credit" for dividends. Thus if a man has a total income from salary, rent, interest, or profits amounting to \$6,000, the method of crediting his income with the amount of any dividends he may receive, providing they are in excess of the \$6,000 of other income, places him on a parity with the most favored taxpayer. It is only persons whose income is partly or wholly from dividends and who have other income less than \$6,000 in amount who suffer.

The existence of this discrimination is no doubt obscured for many taxpayers as well as for many who do not realize that they are tax bearers by the fact that no normal tax is demanded of any person on account of dividends. Probably few of those who by reason of small incomes do not make a return and yet receive dividends ever stop to think that they have been taxed by this method of stoppage at the source. Other sufferers too take their credit for dividends without stopping to think that the dividends (and, for that matter, the undistributed surplus as well) are only 88 per cent of what the company earned for them because the

company has paid 12 per cent in taxes for them; or, if they do know that the tax has been paid at the source, do not realize that measured by the size of their income the 12 per cent is more than they would pay if they held, say, bonds instead of stock.<sup>1</sup>

As the reader will have perceived from the above clumsy statements, the discrimination is not easy to state in general terms. The statement becomes cumbersome and involved because there are so many different factors and variants to be considered. Possibly a few illustrations will make the matter clearer. The following examples do not exhaust the possibilities nor cover all the complications, but are designed to suggest the most important points.

*Example one.* *A* has shares of stock in a corporation, which shares earn, in a year, \$2,000 net.<sup>2</sup> He has no other income. The corporation pays a tax of 12 per cent and gives him \$1,760 (\$2,000 less \$240) as a dividend. If his personal exemption amounts to \$2,000 *A* makes no return and pays no tax himself. He has, however, borne a tax of \$240 paid for him by the company.<sup>3</sup> Had his income been a salary of \$2,000 he would have received the whole of it and have paid no tax. Because he is the recipient of dividends he has lost the benefit of the personal exemption.

*Example two.* *B* has a salary of \$2,000 and owns shares of stock which earn \$3,000. He receives a dividend of \$2,640, the company paying for him a tax of \$360. He makes return of \$4,640 of income, takes his personal exemption of \$2,000 and his "credit" of \$2,640, and pays no tax. But he has lost the benefit of the subnormal tax of 6 per cent on the first \$4,000 (in this case on \$2,640 plus the tax stopped at the source \$360, or on \$3,000), a benefit which would have accrued to him if his income had been in another form. He has borne a tax of \$360 which is twice what he would have paid had he not been so unfortunate as to have part of his income in the form of dividends. In this case it is the benefit of the subnormal tax that is lost.

<sup>1</sup> The case is a little different for dividends in preferred stock. We consider here only the dividends on common stock.

<sup>2</sup> That is, they earn \$2,000 before the payment of the income tax. It is necessary to start with the earnings rather than with the dividends, because we wish to make comparison with other incomes which are received before the tax is paid. It is the only way in which we can compare like items.

<sup>3</sup> No consideration is here given to the complicating detail that the company has an exemption, or more properly a deduction, of \$2,000 from its net income before it computes the tax. That, of course, reduces the tax below 12 per cent, by varying amounts for different companies.

*Example three.* *C* has shares of stock earning \$10,000 and no other income. He receives \$8,800 in dividends, \$1,200 in taxes having been paid for him by the company. He makes return of \$8,800, takes his "credit" as to the normal tax and pays a sur-tax of \$74. Total taxes paid and borne are \$1,274. Had his income of \$10,000 been of any other sort than dividends he would have paid a tax of only \$830. He has lost both benefits, the personal exemption and the subnormal tax as well.<sup>4</sup>

The discrimination may be explained in another way as arising from the attempt to collect at the source a part of a graduated tax on incomes without making provision for refunding or abating taxes, collected in this manner, in excess of the rates which it is intended the individuals should bear. If there were a refunding system, *A* would be entitled to a refund of \$240, *B* to \$180, and *C* to \$434. That is, these are the sums they should receive to put them on a parity with their neighbors of like amounts of income from other sources than dividends.

A very bad feature of the discrimination is that it is regressive. Thus it is 12 per cent of *A*'s income, a poor man, and only 4 per cent and a little over of *B*'s income, a well-to-do man. The regression does not depend on the selection of cases made. It is inherent.

It should be further noted that the discrimination is not often against the active man of large means. He would normally have income, other than from dividends, large enough to entitle him to the full or a large part of the benefits of the personal exemption and of the subnormal tax as well. It falls very often on the inactive small investor, and particularly on the widow, the orphan and the retired business man or worker.

If long continued this discrimination may bring about economic and social changes concerning which it is interesting to speculate, but which can be only briefly suggested here. Thus it will tend to exclude the small investor from the market for common stock and to some extent create a tide favoring the financing of corporations by borrowed money rather than by stock. Whether this would be sound or socially desirable is a question that might be discussed at some length. There seems to be little possibility that the discrimination will be easily engulfed in the tendency for investments

<sup>4</sup> Incidentally, while the government gets \$1,200 as the technical normal tax, instead of \$720, subnormal and normal, it loses by the method of computation \$26 in sur taxes.

to "seek a level." It is too largely personal and too little objective for that.

*A* is not an imaginary individual. *A* is most often a woman and her case seems hard. Why should she bear a tax of \$240 while her neighbor of like amount of income goes free? It is not because her income contains any element of "special privilege," because all of that is taken care of by other taxes. Bad as the discrimination may be, there is another side to the case. The collection of this part of the income tax at the source is a convenience and an economy to the government in the administration of the tax. It prevents, in a very practical manner, a great deal of otherwise possible evasion. It increases the revenue. These are obvious advantages which make for the retention of the plan. I would be the last to assert that expediency should necessarily give way to justice. How much the system increases the government revenues is one of the many important facts concerning the income tax which the government statistics do not fully reveal. The contributions of these many small taxpayers will run into large sums in the aggregate. The time being is not the time when such a loss of revenue can be afforded. But it is well to remember that this discrimination exists and that there is an easy remedy for it in a refunding system. Some day we may be able to afford the remedy.<sup>5</sup>

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<sup>5</sup> David Friday estimates the 1916 dividends paid by corporations at \$3,784,000,000. Dividends reported by taxpayers in 1916 were \$2,136,468,625. Taking round numbers we have 12 per cent of (3,784,000,000 times 1.136 less 2,136,000,000 times 1.136) equals 225,000,000. That is, about \$225,000,000 in taxes is borne by persons receiving dividends and deprived of the benefit of the personal exemption thereon. We are not given the amount of dividends received by persons whose incomes are under \$6,000. For those between \$3,000 and \$5,000 the total is \$28,000,000. It is useless to try to guess at the amount received by those below \$3,000 but who nevertheless are taxable and those between \$5,000 and \$6,000. But it is certain that the discriminations referred to must amount to close upon a quarter of a billion dollars. The precise figure is not so vital, for discrimination is not nice whether it be only thirty cents or three hundred million dollars.